

4.5 The role of foreign direct investment (FDI)

Learning Outcomes

- Describe the nature of foreign direct investment (FDI) and multinational corporations (MNCs).
- Explain the reasons why MNCs expand into economically less developed countries.
- Describe the characteristics of economically less developed countries that attract FDI, including low cost factor inputs, a regulatory framework that favours profit repatriation, and favourable tax rules.
- Evaluate the impact of foreign direct investment (FDI) for economically less developed countries

What is foreign direct investment (FDI)?

FDI is investment by a company in other countries. FDI occurs when a foreign company builds new factories in a country. This is called greenfield inward investment, and when a company buys or leases existing productive assets it is called brownfield inward investment. For example, Coca Cola has invested in an existing factory in Uganda where the drinks are produced and bottled. The purchase by a foreign buyer of 10% or more of the shares of a company is also an example of FDI. When a company invests in productive assets in more than one country, by definition, they are multinational corporations (MNCs). Most FDI is investment by MNCs in productive assets in developing countries. FDI leads to an increase in the flows of **financial capital** into a country.

Why do MNCs locate in developing countries?

A MNC is looking for (or seeking) benefits that are unavailable in their home country. Most of these benefits have the effect of reducing **average costs**. Discussed below are the reasons why an MNC chooses to locate in a country.

Resource seeking

An MNC may locate in a country that has the **resources** it wants for the production of its good, such as **raw materials**, natural resources (e.g. oil and minerals), and a large supply of low skilled labour, all of which maybe unavailable where it is currently located.

Market seeking

An MNC may locate in a country in order to increase the size of its market thereby increasing sales. The MNC may want to take advantage of growing demand for its good in a particular country or region.

Efficiency/lower cost seeking

This reason for FDI is closely linked to the previous reasons. MNCs want to reduce **costs of production**. Locally available resources means that transport costs fall and production is unlikely to be affected by problems in the supply chain.

Where there is a **surplus** of low skilled workers wages will be low thereby reducing costs of production.

MNCs can increase the size of their market by locating in a country. With greater **demand** for its output it can expand production. The MNC can then benefit from greater **economies of scale** thereby reducing average costs. The cost of getting the goods to the market is also reduced.

By locating production in a country an MNC can avoid **barriers to trade** put up by that country. Instead of exporting goods into the country the MNC produces goods in the country, thereby avoiding the **tariffs** or **quotas** placed on imports. The avoidance of tariffs gives the MNC a competitive advantage.

Developed countries have strict health and safety regulations that firms must obey. The costs of complying with the regulations are high. In developing countries regulations are not as strict, therefore an MNC can avoid these costs by locating production in the developing country.

A developing country's government will reduce the **corporation tax** rate and other business taxes in order to attract investment from an MNC. This has the effect of reducing the MNC's costs of production.

Model sentence: MNCs locate in LDCs in order to lower average costs and thereby increase competitiveness and company profits.

Subject vocabulary

financial capital the money used by firms and entrepreneurs to purchase the resources needed to produce goods or services

average costs is equal to total cost divided by quantity of output

resources the inputs into the production process, the factors of production

raw materials the basic material from which a good is made

costs of production the amount the firm pays for the factors of production used to produce goods or services

surplus occurs when quantity supplied is greater than quantity demanded, another term for excess supply

demand the amount of a good that consumers are willing and able to buy at each price

economies of scale the fall in average cost in the long run brought about by an increase in the size of a firm's operation

barriers to trade restrictions imposed by a government on the free exchange of goods or services between countries

tariffs a tax placed on imported goods and services

quotas a physical limit placed on the number of goods that can be traded or produced

corporation tax a tax levied in the UK on company profits

Subject vocabulary

property rights laws concerning how people can control, benefit from, and transfer property

transport infrastructure the physical capital that supports a transport system such as roads, railways, ports, airports

inflation an increase in the general level of prices of goods/services in an economy over a given time period, usually a year

aggregate demand the total demand for goods and services in the economy at a given price level in a given period of time

aggregate supply the total supply of goods and services produced in an economy at a given price level in a given time period

multiplier effect occurs when an initial injection of income into the circular flow causes a larger increase in national income than the initial amount injected

tax revenue the income the government receives through the levying and collection of taxes

direct taxes a tax that is paid directly by an individual or firm to the government. For example income tax on wages and company profits

Human Development Index a composite index that measures a country's achievements in three areas: life expectancy rates, literacy rates, and income per head

technologically advanced capital capital that incorporates new technology and is used in place of existing capital to produce goods and services thereby increasing productivity

productivity the quantity of output per unit of input

industrialization the process in which a country changes its economy from one based primarily on agricultural output into one based on the manufacture of goods

primary goods a good that has not been processed and is in a raw state (e.g. fruit/wheat)

Other factors that MNCs consider

The developing country must be able to provide at least some of the advantages to MNCs described above. The developing country must be politically stable. Civil war and religious conflict can seriously disrupt production and increase costs. MNCs want there to be an effective legal structure that protects property and **property rights** and enforces business contracts. **Transport infrastructure** must be good enough for the firm to be able to transport its goods efficiently to its markets.

An MNC wants to be able to repatriate profit so that profit can flow easily from the developing country to the MNC's home country. The MNC wants to exchange the foreign currency for their domestic currency when repatriating profits. If the developing country's government has put in place limits on the amount of capital that can flow out from the country the MNC may choose not to invest in that country. Some developing countries charge a 0% tax rate on all reinvested profit in order to reduce the amount of income leaving the country.

An MNC considers the macroeconomic conditions in a country. For example, an MNC will be put off investing in a country that has high rates of **inflation**.

Evaluate the effects of FDI on developing countries

Discussed below are the possible benefits gained by developing countries that attract FDI.

Explain the effects on employment, income, and tax revenues of FDI

FDI is an injection of capital into the economy of the developing country. An MNC uses some of a developing country's factors of production in order to make goods. In particular, FDI has a direct impact on employment and income. An MNC employs labour for which it pays a wage. Unemployment falls and income increases.

FDI also has an indirect impact on employment and income. A proportion of the extra income earned by those employed by the MNC is spent by households on goods and services, thereby increasing the amount of money flowing to other firms in the economy which in turn flows to households as income. As incomes rise **aggregate demand** increases, leading to an increase in **aggregate supply** and a fall in unemployment. FDI is an injection into the circular flow of income of the developing country and injections create a **multiplier effect** (see pages 134–37 for a detailed explanation of the multiplier effect).

FDI directly increases demand for goods and services from domestic businesses that can supply the MNC with raw materials, capital goods, and services.

Indirect tax is tax on expenditure. As wages increase spending increases, therefore **tax revenue** increases. **Direct tax** is a tax on income. As unemployment falls and more people are earning a wage, tax revenue increases.

The MNC's profit is also taxed therefore, tax revenue increases. The extra tax revenue may be spent by the government on education and health services thereby increasing the value of the country's **Human Development Index**.

Model sentence: FDI reduces unemployment, increases income and raises tax revenue.

Explain the effects on skills, technology, and productivity of FDI

Developing countries look to FDI from an MNC to provide training, expertise, and **technologically advanced capital**. New skills are learned, increasing the productivity of the workers. Managers in the developing country learn about efficient management techniques. These benefits will eventually reach other industries.

An MNC employs the most productive, up-to-date, capital which the developing country would not be able to afford. This provides an incentive for domestic firms to use more advanced capital. Domestic producers in the same industry will need to increase **productivity** if they are to compete successfully with the MNC. FDI creates a competitive environment and in order to survive firms must increase productivity leading to a more efficient use of scarce resources.

Model sentence: FDI is seen by governments of developing countries as a way to speed up the process of **industrialization** thereby reducing the country's dependency on the production of **primary goods**.

Explain the effects on the national accounts of FDI

FDI is an inward flow of money used for the purchase of a country's assets which is recorded on the capital account of the balance of payments. This increase of money flowing in to a developing country is a valuable source of foreign currency, allowing for the purchase of a greater quantity of imported consumer goods and **capital** goods.

However, there are other effects. An MNC's repatriated profits and money spent by the MNC on imported goods, such as raw materials, leads to an increase in the flow of money out of the country and is recorded as a negative value on the **current account**. If the MNC exports goods then money flows into the country from abroad and is recorded as a positive value on the current account. Many buyers in the country buy the good produced by the MNC in that country instead of imported goods. Therefore the money flowing out of the country for the purchase of imports falls.

Model sentence: The overall effect of FDI on the current account balance is determined by the relative size of the changes to the inflows of money from the sale of exports and the outflows of money from the purchase of imports.

The possible disadvantages of FDI

Discussed below are some of the drawbacks associated with FDI.

Explain the effects of political instability in developing countries

FDI is risky because the political conditions in some developing countries can change very quickly. Agreements made with one government may not be kept by a new government. MNC's assets might be seized by the government or tax advantages withdrawn.

Explain the effects of MNCs' influence on the governments of developing countries

MNCs sometimes put pressure on governments of developing countries to pass laws and introduce policies that are in their own interests but against the interests of the citizens and workers of the country. For example, health and safety regulations may be reduced or not enforced. **Natural resources** may be allowed to be overused and **negative externalities** caused by emissions ignored.

Explain how MNCs exploit the resources in developing countries

As stated above, an MNC may overuse the host country's natural resources in order to make gains in the short-term. The MNC's profits increase at the expense of **sustainable economic development** of the host country.

If an MNC is a **monopsonist**, wages can be pushed down. If the MNC is the largest employer or the only employer of low skilled workers in an area of the country it has the power in the **labour market** to push wages down. An MNC may also have **monopoly power** and can use this power to increase profits paid to the owners at the expense of payments paid to the other **factors of production** and restrict supply to increase prices and profit.

Explain why an increase in tax revenue from FDI is limited

In order to attract FDI the government of the developing country must charge low rates of corporate and business taxes, limiting any increase in tax revenue. When the government eventually increases the tax rate the MNC deliberately reduces its tax burden through the use of certain accounting practices. MNCs have branches in many countries. In effect the MNC transfers some of the profit made in the country where the tax rate is higher to a branch where the tax rate is lower.

Explain what happens to MNCs' profit

Not all income earned by the factors of production employed by an MNC stays in the developing country. Profit, which represents a large proportion of total income earned, is sent back to the MNC's home country.

The income that is spent in developing countries comes from the wages paid to the workers and the income spent on domestically produced inputs such as locally produced capital and raw materials.

Profit repatriation is a flow of money out of the economy. It is not spent in the economy and therefore does not contribute to economic growth and development.

Subject vocabulary

capital (goods) manufactured goods that are used in the production of other goods

current account a record of the amount of money flowing out of a country and into the country from the rest of the world from the trade in goods and services, investment income, and transfers in a given period of time

natural resources assets, such as mineral deposits and timber, that occur in nature and can be used in production

negative externalities occur when the production or consumption of a good creates costs that must be paid by third parties. The existence of negative externalities means that social cost is greater than private cost.

sustainable economic development economic growth that meets the needs and wants of the current generation in such a way that does not prevent future generations from meeting their needs and wants

monopsonist a firm or industry that is a single buyer of the product or service of many sellers

labour market a market in which firms demand labour and workers supply labour. The interaction of demand and supply of labour determines the equilibrium wage.

monopoly power the degree of control a firm has over the setting of price.

factors of production the inputs into the production process (land, labour, capital and entrepreneurship)

profit repatriation occurs when the profits earned on assets in one country go to the owners of the assets in another country

Subject vocabulary

loanable funds the sum of money in an economy that is saved rather than used for consumption and made available to those wishing to borrow

interest rates the percentage amount charged by a lender for money borrowed or paid to a person for saving money

capital manufactured goods that are used in the production of other goods

economies of scale the cost advantages gained by a firm from increasing the scale of its production. Average cost falls in the long run as the size of a firm's operation increases.

average costs is equal to total cost divided by quantity of output

barriers to entry factors that prevent/make difficult the entry of new firms into an industry or market

labour-intensive describes production that requires a large amount of labour relative to the amount of capital

intermediate technology technology that is appropriate for use in less developed countries that allows making use of the country's available resources and skills

Some MNCs do not always use their own money for investment. Sometimes an MNC borrows from the local financial institutions. The increase in demand for **loanable funds** pushes up the **interest rates** and crowds out domestic firms that want to borrow.

Explain the effects of monopoly power on local businesses in developing countries

An MNC uses technologically advanced **capital** and benefits from **economies of scale** which pushes down **average costs**. Existing local firms find it very hard to compete. They lose customers to the MNC and are forced to lower their prices thereby reducing profits. Those that are unable to reduce average cost enough go out of business and workers lose their jobs. This increases the monopoly power of the MNC and it can dominate the market. **Barriers to entry** into the industry will be very high restricting entrepreneurial activity in the area.

Explain the effects of using inappropriate technology in developing countries

Developing countries have a surplus of low skilled workers and therefore it would be appropriate to use **labour-intensive** methods of production using **intermediate technology**. An MNC uses capital-intensive methods of production therefore the demand for low skilled workers is low, limiting the number of local people employed and the amount of extra income spent in the local economy.

Test your understanding of this unit by answering the following questions

- Explain how FDI might affect the current account balance.
- How might the levels of employment and income in a developing country be affected by FDI?
- Why do MNCs locate in developing countries?
- Evaluate the effects of FDI for developing countries.